

**Management Advisory Report: Concerns with
the Processing of Small Business Corporation
Returns at the Atlanta Processing Center
in July 1999**

June 2001

Reference Number: 2001-30-080

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 13, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Concerns with the
Processing of Small Business Corporation Returns at the Atlanta
Processing Center in July 1999

This report presents the results of our review of allegations that employees in the Atlanta Processing Center prematurely removed cases from inventory in July 1999 rather than send required letters to taxpayers or wait the required time period for them to respond.

In summary, some taxpayers attempting to file U.S. Income Tax Returns for an S Corporation (Form 1120S) at the Atlanta Processing Center were harmed because the Internal Revenue Service (IRS) did not take necessary actions. The taxpayers attempted to file Forms 1120S, but the IRS claimed there was no record of required elections to file these returns. Because the IRS did not adhere to prescribed procedures, taxpayers were not always given ample opportunity to provide the IRS with documentation to ensure that correct tax return information was processed to their accounts. In addition, the IRS did not always process returns as small business corporation returns once it verified that taxpayers had proper elections to file these returns.

This management advisory report is being provided for informational purposes. Since we are making no recommendations, a response to this report is not required. Copies of this report are also being sent to the IRS managers affected by the report.

Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs) at (202) 622-3837.

**Management Advisory Report: Concerns with the Processing of Small Business
Corporation Returns at the Atlanta Processing Center in July 1999**

Table of Contents

Executive Summary.....	Page i
Objective and Scope.....	Page 1
Background	Page 1
Results	Page 3
Tax Examiners Sent Required Letters But Did Not Wait for Taxpayers to Reply in More Than Half of the Cases Reviewed	Page 4
Tax Examiners Did Not Always Send Required Letters to Taxpayers that Filed Forms 1120S to Inform Them There Was No Record of Their Elections to File Forms 1120S	Page 5
The Internal Revenue Service Did Not Always Process Returns as Forms 1120S Once It Verified that the Elections Were Granted to File These Returns	Page 7
Conclusion.....	Page 9
Appendix I – Detailed Objective, Scope, and Methodology	Page 10
Appendix II – Major Contributors to This Report.....	Page 11
Appendix III – Report Distribution List.....	Page 12

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Executive Summary

This review was conducted as a result of allegations that employees in the Internal Revenue Service (IRS) Atlanta Processing Center prematurely removed cases from inventory in July 1999 and then did not either send required letters to taxpayers or wait the required 30 days for them to respond. The taxpayers attempted to file a U.S. Income Tax Return for an S Corporation (Form 1120S), but the IRS claimed there was no record that the taxpayers had filed the required Election by a Small Business Corporation (Form 2553). Taxpayers are required by the IRS to file a Form 2553 to elect to be treated as a small business corporation.

The IRS instructs tax examiners to send letters to taxpayers that file Forms 1120S when there is no record of elections to file these returns. However, in these cases, the tax examiners were allegedly instructed to follow procedures generally used in “no response” situations to prematurely remove the cases from inventory. This primarily occurred in July 1999, allegedly to reduce inventory and make the work unit appear more productive.

Our overall objective was to determine if problems occurred in the processing of small business corporation returns that resulted in harm to taxpayers.

Results

Some taxpayers that attempted to file a Form 1120S at the Atlanta Processing Center were harmed because necessary actions were not taken during July 1999 processing. IRS employees prematurely removed cases from inventory in July 1999 rather than either sending required letters or waiting the prescribed time period for taxpayers to respond. Also, the IRS did not always process these returns as small business corporation returns once it verified that the taxpayers had proper elections to file these returns.

Tax Examiners Sent Required Letters But Did Not Wait for Taxpayers to Reply in More Than Half of the Cases Reviewed

The IRS sent required letters to taxpayers but did not allow the proper time period (30 days) for taxpayers to respond in approximately 59 percent of the cases we reviewed.¹ Based on our statistically valid sample, we estimate that in July 1999, this involved

¹ In 81 of the 176 cases in our sample, the Integrated Data Retrieval System and/or case files showed evidence of the required 429C Letter being sent and the related dates. We reviewed the 81 cases where date information was available to determine if the IRS allowed the proper time for the taxpayers to respond. In 48 of the 81 cases (59 percent), the proper time period was not allowed.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

352 taxpayers.² Letters were sent on the same date the case was closed or within 1 to 3 days of closing the case for most of these taxpayers. Because tax examiners removed cases from inventory without allowing the prescribed time period to receive and review taxpayers' responses, these taxpayers could not be assured that any problems they may have had in filing Forms 1120S were properly and timely resolved.

Tax Examiners Did Not Always Send Required Letters to Taxpayers that Filed Forms 1120S to Inform Them There Was No Record of Their Elections to File Forms 1120S

Tax examiners did not send required letters to an estimated 227 small business corporate taxpayers,³ whose returns were processed in July 1999, to inform them that the IRS had no record of their elections to file Forms 1120S. As a result, these taxpayers were not given the opportunity to respond to the IRS either with verification that the IRS had previously granted the elections or with U. S. Corporation Income Tax Returns (Form 1120). Also, in those cases where an election form had not been filed on time, shareholders were not instructed to file amended individual returns when they reported Form 1120S losses or gains. Our review of a sample of cases showed that corporate shareholders could have been wrongfully taxed on their individual income tax returns for gains totaling \$201,424, or could have been subject to Examination scrutiny for incorrect losses totaling \$691,085, because business returns were not processed as Forms 1120S.

The Internal Revenue Service Did Not Always Process Returns as Forms 1120S Once It Verified that the Elections Were Granted to File These Returns

When Forms 1120S were not processed because it was believed that there was no record of elections to file these returns, the Forms 1120S were processed to taxpayers' accounts as Forms 1120. When the IRS subsequently verified that taxpayers were granted elections to file Forms 1120S, the taxpayers' accounts should have been adjusted to accurately reflect the filing of Forms 1120S. However, the IRS did not convert corporate

² The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the population of 1,290 cases, we first applied the percentage of cases where dates were available (81/176 or 46 percent), then the percentage of cases where the proper response time was not allowed (48/81 or 59 percent), to arrive at the 352 cases.

³ The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the population of 1,290 cases, we applied the percentage of cases where there was no evidence that required 429C Letters were sent (31/176 or almost 18 percent) to arrive at the 227 cases.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

income tax returns to small business corporation returns for an estimated 205 taxpayers⁴ with returns processed in July 1999, once the IRS had, in fact, verified that elections were granted. There was the potential for inconsistent treatment of taxpayers, incorrect and incomplete tax information on file, and unnecessary burden for both corporate taxpayers and shareholders in having to contact the IRS to abate taxes and ensuring that they have accurate returns on file.

Summary of Recommendations

This report is advisory in nature and is being provided for informational purposes for whatever actions that may be deemed necessary. Consequently, we are not making any recommendations.

⁴ The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the population of 1,290 cases, we first applied the percentage of cases in which elections to be treated as a Form 1120S had effective dates of 1998 and prior (68/176 or almost 39 percent), then the percentage of cases that were not processed as Forms 1120S (28/68 or 41 percent), to arrive at the 205 cases.

Objective and Scope

Our overall objective was to determine if problems occurred in the processing of small business corporation returns that resulted in harm to taxpayers.

Our overall objective was to determine if problems occurred in the processing of U.S. Income Tax Returns for an S Corporation (Form 1120S) that resulted in harm to taxpayers. To assess whether small business taxpayers were harmed, we reviewed employee allegations, held discussions with Internal Revenue Service (IRS) management at the Atlanta Processing Center, and reviewed tax returns and related IRS files to identify instances in which taxpayers may have been harmed.

The review was conducted from January to April 2001 at the Atlanta Processing Center and included transactions for the period July 1999. The review began promptly after the Treasury Inspector General for Tax Administration's Office of Investigations requested our assistance on allegations that they were investigating. We conducted this review in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*.

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

We conducted the review based on allegations that employees in the Atlanta Processing Center prematurely removed cases from inventory in July 1999, then did not either send required letters (429C Letters)¹ to taxpayers or wait the required time period (30 days) for them to respond. If a taxpayer files a Form 1120S and the IRS has no record of the required Election by a Small Business Corporation (Form 2553) being filed, the

¹ The title of the 429C Letter is, "Form 8832, Entity Classification Election Rejection/Denial or S Corporation Return Incomplete for Processing: Form 1120S."

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

The IRM instructs tax examiners to send taxpayers letters in an attempt to resolve the filing of Forms 1120S that cannot be processed to taxpayers' accounts.

Form 1120S cannot be processed to the taxpayer's account.

The Internal Revenue Manual (IRM) instructs tax examiners to send taxpayers 429C Letters in an attempt to resolve the filing of Forms 1120S that cannot be processed to taxpayers' accounts. The 429C Letter informs taxpayers that:

- ◆ The IRS is unable to process the return using the Form 1120S.
- ◆ The IRS has no record of the Form 2553 election to be treated as an S corporation.
- ◆ The taxpayer needs to inform all shareholders to amend their individual income tax returns for the year involved if they reported the Form 1120S income or loss.
- ◆ The Form 1120S will be processed as a U.S. Corporation Income Tax Return (Form 1120), unless the taxpayer can provide documentation that he/she was granted the election to file a Form 1120S.
- ◆ Their account may reflect incomplete or incorrect information if a response is not received within 30 days from the date of the letter.

At the Atlanta Processing Center, the tax examiners were allegedly instructed to follow a procedure generally used in "no response" situations to prematurely remove the cases from inventory. This primarily occurred in July 1999, allegedly to reduce inventory and make the unit appear more productive.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Results

In July 1999, employees prematurely removed cases from inventory at the Atlanta Processing Center and did not either send required letters to taxpayers or wait the required time period for taxpayers to respond.

We found that, as alleged, in July 1999 employees prematurely removed cases from inventory at the Atlanta Processing Center and did not either send required letters to taxpayers or wait the required 30 days for taxpayers to respond. The taxpayers attempted to file Forms 1120S, but the IRS claimed there was no record of required elections to file these returns. The Forms 1120S were generally processed as Forms 1120 because taxpayers were not always given the opportunity to provide documentation to indicate whether they were granted the elections to file Forms 1120S.

Managers did not always ensure that required procedures were being followed and that all necessary actions were taken, nor did they request permission to deviate from IRS procedures. Because necessary actions were not taken, taxpayers were harmed by:

- ◆ Not being given the opportunity to respond to the IRS with verification that the election was granted by the IRS.
- ◆ Not being allowed to respond with a Form 1120, if they were not granted an election, to prevent their tax accounts from reflecting inaccurate or incomplete information.
- ◆ Along with shareholders, having to respond to the IRS to have taxes abated and ensure that they had an accurate and proper return on file.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Tax Examiners Sent Required Letters But Did Not Wait for Taxpayers to Reply in More Than Half of the Cases Reviewed

The IRS sent required 429C Letters to an estimated 352 taxpayers in July 1999 but did not allow the proper time period (30 days) for the taxpayers' responses.

The IRS sent required 429C Letters to taxpayers but did not allow the proper time period (30 days) for taxpayers to respond in approximately 59 percent of the cases we reviewed.² Based on a statistically valid sample, we estimate that in July 1999, this involved 352 taxpayers.³ Letters were sent on the same date the case was closed or within 1 to 3 days of closing the case for most of these taxpayers.

The initial allegation was that the premature closing of these cases was done to reduce inventory and make the unit appear more productive. Managers indicated that this practice primarily occurred in July 1999 and ended after a month.

Taxpayers were not given the prescribed time period to respond to the letters before the IRS treated them as "no response" cases. Because tax examiners removed cases from inventory without allowing time for the receipt and review of taxpayers' responses, taxpayers could not be assured that any problems they may have had in filing Forms 1120S were properly and timely resolved.

In some cases, it took anywhere from a month to a year after the IRS sent taxpayers the 429C Letters for them to be granted the elections to file Forms 1120S. In other cases, elections to file Forms 1120S had already been

² In 81 of the 176 cases in our sample, the Integrated Data Retrieval System and/or case files showed evidence of the required 429C Letter being sent and the related dates. We reviewed the 81 cases where date information was available to determine if the IRS allowed the proper time for the taxpayers to respond. In 48 of the 81 cases (59 percent), the proper time period was not allowed.

³ The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the population of 1,290 cases, we first applied the percentage of cases where dates were available (81/176 or 46 percent), then the percentage of cases where the proper response time was not allowed (48/81 or 59 percent), to arrive at the 352 cases.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

granted for subsequent tax periods, but taxpayers had to submit Forms 1120 for the tax years not covered by the elections to ensure that their accounts reflected accurate and complete information. We could not determine if the delays in granting the elections were caused by the premature closing of the cases.

Tax Examiners Did Not Always Send Required Letters to Taxpayers that Filed Forms 1120S to Inform Them There Was No Record of Their Elections to File Forms 1120S

Tax examiners did not send required 429C Letters to an estimated 227 small business corporate taxpayers, whose returns were processed in July 1999, to inform them that the IRS had no record of their elections to file Forms 1120S.

Tax examiners did not send required 429C Letters to an estimated 227 small business corporate taxpayers, whose returns were processed in July 1999, to inform them that the IRS had no record of their elections to file Forms 1120S.⁴ This occurred in approximately 18 percent of the cases that we reviewed (31 of 176).⁵ The initial allegation had indicated that required letters were not being sent to taxpayers.

Managers did not always ensure that all required letters were being sent to these taxpayers, nor did they request permission to deviate from procedures. Because 429C Letters were not sent in these 31 cases:

- ◆ Taxpayers did not get the opportunity to respond to the IRS with verification that the Forms 2553 were accepted and timely filed.

⁴ The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the population of 1,290 cases, we applied the percentage of cases where there was no evidence that required 429C Letters were sent (31/176 or almost 18 percent) to arrive at the 227 cases.

⁵ A review of IRS computer transcripts and records, tax returns, and related files showed no indications that the required 429C Letter was sent in these cases and no indication that an election was granted to these taxpayers.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Because the IRS did not adhere to prescribed procedures, taxpayers were not provided ample opportunity to furnish the IRS with needed documentation to ensure that their correct return was posted to the IRS' records.

- ◆ Taxpayers were not given the opportunity to file Forms 1120 to ensure that their information filed with the IRS was complete and correct.
- ◆ Shareholders were not instructed to file amended individual returns when they reported Form 1120S losses or gains but did not have timely elections filed. As a result, corporate shareholders could have been wrongfully taxed on gains totaling \$201,424 or could have incorrectly received tax benefits on their individual income tax returns from losses of \$691,085 reported on Forms 1120S that were not processed.

Of the 31 cases:

- ◆ Gains totaling \$201,424 resulted in taxes of \$32,676 being assessed on 9 corporations, and corporate shareholders could have also been taxed on these gains if amended individual returns were not filed.
- ◆ Shareholders of 18 corporations could have incorrectly received tax benefits and been subjected to Examination scrutiny for incorrect losses totaling \$691,085, if amended individual returns were not filed. These losses appeared on the originally filed Forms 1120S. However, when Forms 1120S could not be processed to the taxpayers' accounts, the IRS converted the Forms 1120S to Forms 1120. Consequently, related losses cannot be included on the individuals' returns.
- ◆ Four cases involved inactive corporations showing no income or losses.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

The Internal Revenue Service Did Not Always Process Returns as Forms 1120S Once It Verified that the Elections Were Granted To File These Returns

The IRS did not convert corporate income tax returns to small business corporation returns for an estimated 205 taxpayers in July 1999, once it verified that elections were granted.

Once the IRS verified that elections to file Forms 1120S were granted, it did not convert corporate income tax returns back to small business corporation returns for an estimated 205 taxpayers in July 1999.⁶ This represented approximately 41 percent of the cases we reviewed. We could not readily determine if this resulted directly from the premature closing of cases.

These taxpayers attempted to file Forms 1120S that could not be processed to their accounts because the IRS had no record of the required Form 2553 elections being filed. When the IRS determined that these returns could not be processed, the Forms 1120S were converted to Forms 1120 and processed to taxpayers' accounts. When the IRS subsequently received verification that the taxpayers were granted the elections to file Forms 1120S, the taxpayers' accounts should have been adjusted to accurately reflect the filing of the Forms 1120S.

There were 68 cases in our sample that were granted the elections to be treated as small business corporation returns, and 28 (41 percent) were not converted to Forms 1120S as of August 2000. Only 34 were processed as Forms 1120S; the remaining 6 involved

⁶ The estimate is based on the results of our review of a statistical sample of 176 cases and is projected for the population of 1,290 cases. Against the 1,290 cases, we first applied the percentage of cases in which elections to be treated as a Form 1120S had effective dates of 1998 and prior (68/176 or almost 39 percent), then the percentage of cases that were not processed as Forms 1120S (28/68 or 41 percent), to arrive at the 205 cases.

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

prior year returns and cases where the elections were terminated or reversed.⁷

Of the 28 cases that were not converted to Forms 1120S,⁸ 16 cases showed total taxes assessed of \$117,887; \$105,609 was subsequently abated on the corporate tax returns. Taxes due after abatements totaled \$12,278. Eleven of the 28 cases involved losses claimed totaling \$169,288, and 1 case showed no tax due.

Initial indications showed that controls may have to be strengthened to ensure that the IRS adjusts the account to accurately reflect the filing of the Form 1120S once it grants the election with an effective date covering the original return. We plan to address this issue in a subsequent review.

As a result, there is the potential for:

- ◆ Inconsistent treatment of taxpayers.
- ◆ Incorrect and incomplete tax information on file.
- ◆ Unnecessary taxpayer burden for both corporate taxpayers and shareholders in having to contact the IRS to abate taxes and ensuring that the IRS has an accurate return on file.

⁷ Of the sample of 176 cases in our review, 99 were granted elections to be treated as a Form 1120S Corporation. Of these 99, 68 were granted with effective dates in 1998 and prior, 20 were effective in 1999, and 11 were effective in 2000. Because the allegation primarily related to the cases processed in July 1999, we concentrated on cases with effective dates of 1998 and prior.

⁸ The 28 cases were closed with a Resolution Code 8 (generally used for “no response” cases) on July 8, 15, and 22, 1999. The transaction dates for granting the taxpayers the election generally ranged from February 4, 1997, through July 18, 2000, but one case was as early as October 4, 1994. (Three cases were granted elections prior to the closing date.)

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Conclusion

Because necessary actions were not taken in many of the cases reviewed, some business taxpayers were harmed.

As alleged, in July 1999, tax examiners prematurely removed cases from inventory at the Atlanta Processing Center rather than send required letters and wait for taxpayers to respond. Because necessary actions were not taken, some business taxpayers were harmed.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if problems occurred in the processing of small business corporation returns that resulted in harm to taxpayers. To achieve the objective, we:

- I. Held discussions with management at the Atlanta Processing Center to identify the controls over processing U.S. Income Tax Returns for an S Corporation (Form 1120S) that could not be processed. The Forms 1120S could not be processed to the Internal Revenue Service's (IRS) computer system because there was no record of an Election by a Small Business Corporation (Form 2553) on file.
- II. Obtained and reviewed Internal Revenue Manual instructions regarding the criteria for closing cases that could not be processed to the IRS Masterfile (the IRS' main computer system of tax accounts).
- III. Reviewed the historic file of returns that could not be processed to the Masterfile (Unpostable Code 310) for January 1999 through December 1999 and identified 18,983 tax returns for the Atlanta Processing Center. From this population, we identified 1,290 tax returns that were processed in July 1999.¹ This was the time period about which an allegation had been made that employees at the Atlanta Processing Center prematurely removed cases from inventory rather than send required letters to taxpayers or wait the required period of time for them to respond.
- IV. Selected and reviewed a statistically valid sample of 176 of the 1,290 tax returns. Using attribute sampling, we determined the sample size of 176 by using a 95 percent confidence level, a 5 percent expected rate of occurrence, and a precision rate of a plus or minus 3 percent.
- V. Reviewed tax returns, computer transcripts, etc., to identify instances in which taxpayers may have been harmed.

¹ We reviewed the historic Unpostable Code 310 file for January 1999 through December 1999 and identified 18,983 Unpostable Code 310s from the Atlanta Processing Center. We then identified 1,290 tax returns in which employees input a Resolution Code 8 (generally used for "no response" cases) in July 1999, with Reason Codes that primarily relate to Form 1120S returns.

Major Contributors to This Report

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)

Richard J. Dagliolo, Director

Robert K. Irish, Audit Manager

Michael D. Luongo, Senior Auditor

Carol Gerken, Auditor

Management Advisory Report: Concerns with the Processing of Small Business Corporation Returns at the Atlanta Processing Center in July 1999

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner C:D
Director of Communications S:COM
Director of Internal/External Stakeholders S:C:CP:I
Chief Counsel CC
Director, Legislative Affairs CL:LA
Office of Management Controls N:CFO:F:M
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division S
 Commissioner, Wage and Investment Division W